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PASS CEA (MALKIEL), TREASURY (WIDMAN), FRB.

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TAGS: ECON, OECD

SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE (EDRC)

REVIEW OF U.S., JULY 9, 1976

REFS: (A) EDR(76)19, (B) OECD PARIS 20588

1. SUMMARY: AT JULY 9 EDRC REVIEW U.S. DEL (MALKIEL) AND SECRETARIAT AGREED THAT SHORT-TERM OUTLOOK FOR U.S. ECONOMY WAS FOR CONTINUED MODERATE, STEADY EXPANSION AND FOR RELATIVE PRICE STABILITY. EDRC DISCUSSION THUS FOCUSED ON RISKS AND UNCERTAINTIES SURROUNDING THIS OUTLOOK AND THE POLICY IMPLICATIONS THEREOF. U.S. PRESENTATION AND COGENT ANSWERS TO QUESTIONS POSED WERE PARTICULARLY EFFECTIVE IN DEVELOPING EDRC SUPPORT FOR U.S. POSITION ON ISSUES WHERE SECRETARIAT AND U.S. VIEWS DIFFERED. U.S. TOOK SHARP ISSUE WITH SECRETARIAT CONTENTION THAT THERE IS SUBSTANTIAL RISK PROFIT INCREASE COULD SET OFF WAGE EXPLOSION AT LATER STAGE OF RECOVERY AND THAT RESTRAINT OF PROFIT AND WAGE INCREASES THROUGH

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AN INCOMES POLICY WOULD BE APPROPRIATE SUPPLEMENT TO

DEMAND MANAGEMENT POLICIES. EDRC, LED BY PARTICULARLY HELPFUL STATEMENT BY CANADIAN EXAMINER (SLATER), SUPPORTED U.S. POSITION THAT FOR ECONOMIC AND INSTITUTIONAL REASONS IMPLEMENTATION OF AN INCOMES POLICY IN THE U.S. WAS UNNECESSARY AND WOULD BE COUNTERPRODUCTIVE. CONCLUSIONS OF REVISED DRAFT SURVEY WILL REFLECT EDRC CONSENSUS ON THIS ISSUE. FOLLOWING DETAILED PRESENTATION OF ADMINISTRATION AND CONGRESSIONAL BUDGET PROPOSALS FOR FY77, SECRETARIAT ALTERED ITS CONCLUSION THAT MARKED REDUCTION OF FISCAL POLICY STIMULUS LIKELY TO OCCUR. MOREOVER, BY POINTING OUT THAT RECENT LOWERING OF TOLERANCE RANGES FOR GROWTH OF MONETARY AGGREGATES WAS RESPONSE TO PROBABLE DOWNWARD SHIFT IN DEMAND FOR MONEY, U.S. DISPELLED SECRETARIAT CONCERN THAT THIS MOVE INDICATED TIGHTENING OF MONETARY POLICY. U.S. STRESSED THAT GUIDELINES FOR MONETARY GROWTH SHOULD BE INTERPRETED AS FLEXIBLE RANGES RATHER THAN AS RIGID TARGETS, AND THAT MONEY SUPPLY WOULD BE ADEQUATE TO LUBRICATE CONTINUED EXPANSION. IN DISCUSSION OF CURRENT ACCOUNT DEVELOPMENTS, U.S. (WIDMAN) SAID THAT FACTORS INFLUENCING EXCHANGE RATE MOVEMENTS WERE NUMEROUS, AND INSISTED THAT IMPLICATION IN REFDOC THAT EFFECTIVE DOLLAR EXCHANGE RATE "CORRECT" RELATIVE TO U.S. RELATIVE COST POSITION INTERNATIONALLY BE SUPPRESSED IN REVISED DRAFT SURVEY. SECRETARIAT AGREED. EDRC CONCLUDED THAT (A) U.S. ECONOMY LIKELY TO CONTINUE ON PATH OF STEADY, NON-INFLATIONARY GROWTH; (B) MAJOR RISK TO U.S. GROWTH IS REVIVAL OF INFLATION; CONTROL OF INFLATION IN U.S. ALSO ESSENTIAL TO MAINTENANCE OF GLOBAL ECONOMIC STABILITY; (C) PRUDENT STANCE OF DEMAND MANAGEMENT POLICY CONSISTENT WITH CONTINUED EXPANSION AND PRICE STABILITY AND IS THEREFORE APPROPRIATE. SECRETARIAT PLANS TO PUBLISH ADVANCE COPY OF U.S. SURVEY IN EARLY AUGUST; FINAL, BOUND VERSION WILL BE PUBLISHED AT A LATER DATE. END SUMMARY.

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: U.S. (MALKIEL) STRESSED THAT BUOYANT GNP GROWTH IN FIRST QUARTER 1976 (8.7 PERCENT ANNUAL RATE), LED BY INCREASE IN RETAIL SALES AND STOCK ACCUMULATION, HAD CONFIRMED LIMITED OFFICIAL USE

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STRENGTH OF THE PRESENT RECOVERY. WHILE GROWTH RATE SLACKENED IN SECOND QUARTER OF YEAR, A BRIEF PAUSE FOR CONSOLIDATION OF RECOVERY CONSIDERED HEALTHY, AND OVERALL GROWTH PERFORMANCE IN FIRST HALF OF THIS YEAR EXCEEDED EVEN OPTIMISTIC OFFICIAL FORECASTS MADE IN JANUARY.

3. MOREOVER, U.S. SAID THAT OUTLOOK FOR INCREASED

INVESTMENT AND HENCE FOR A DURABLE EXPANSION WAS FAVOR-
ABLE FOR FOLLOWING REASONS: (A) BUSINESS PROFITS SIGNI-
FICANTLY IMPROVED; (B) CORPORATE BALANCE SHEETS IN
ADVANCED STATE OF REPAIR; (C) REDUCED INFLATION RATE HAS
LED TO FAVORABLE CONDITIONS IN FINANCIAL MARKETS;
(D) BUSINESS INVESTMENT PLANS REVISED UPWARD AND CON-
CRETE EVIDENCE OF RENEWED BUSINESS CONFIDENCE REFLECTED

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IN INCREASED ORDERS FOR INVESTMENT GOODS. SECRETARIAT
AGREED WITH U.S. EXPECTATION THAT GROWTH OF FIXED
INVESTMENT WOULD REPLACE CONSUMER SPENDING AND STOCK
ACCUMULATION AS MAIN SUPPORT TO RECOVERY, AND THAT REAL
GNP WOULD GROW BY 7 PERCENT IN 1976 AND BY 6.3 PERCENT
(ANNUAL RATE) IN FIRST HALF OF 1977.

4. EMPLOYMENT: SECRETARIAT SOUGHT EXPLANATION FROM
U.S. FOR STRONG RISE IN EMPLOYMENT AND MODEST (COMPARED
TO PREVIOUS RECOVERIES) INCREASE IN PRODUCTIVITY IN
PRESENT RECOVERY. U.S. EMPHASIZED THAT INCREASE IN

EMPLOYMENT LARGELY RESULT OF EXPANSION OF SERVICE SECTOR, WHEREAS EMPLOYMENT GROWTH IN MANUFACTURING SECTOR HAS BEEN MUCH LESS PRONOUNCED. U.S. ALSO NOTED THAT GROWTH IN EMPLOYMENT IN EARLY 1976 SOMEWHAT OVERSTATED BECAUSE OF SEASONAL ADJUSTMENT QUIRKS. U.S. POINTED OUT THAT SHIFT IN COMPOSITION OF LABOR FORCE TOWARD INCREASED PROPORTION OF PERSONS POSSESSING LESS HUMAN CAPITAL HAD LOWERED AVERAGE LABOR PRODUCTIVITY. U.S. CITED REDUCED PRODUCTIVITY AS MAIN REASON WHY GROWTH OF U.S. POTENTIAL LIMITED OFFICIAL USE

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OUTPUT MIGHT BE SOMEWHAT LESS THAN PAST TREND INCREASE OF 4 PERCENT. DOWNWARD ADJUSTMENT OF GROWTH OF POTENTIAL WOULD ALSO RESULT IN GREATER SHRINKAGE OF "GNP GAP" FOR ANY INCREASE IN ACTUAL OUTPUT. THIS IMPLIES (THROUGH OKUN'S LAW) A STRONGER LINK BETWEEN EMPLOYMENT AND OUTPUT.

5. PRICES: U.S. COMMENTED THAT UNUSUALLY LOW INFLATION RATE IN FIRST QUARTER OF 1976 (CPI AND GNP DEFLATORS ROSE BY 3.5 PERCENT AND 3.6 PERCENT ANNUAL RATE RESPECTIVELY) LARGELY DUE TO TEMPORARY DECLINES IN FOOD AND ENERGY PRICES, AND THAT MODERATE INCREASES IN THESE COMPONENTS LIKELY DURING REMAINDER OF YEAR. BASED ON OFFICIAL EXPECTATIONS THAT FOOD AND ENERGY PRICES WOULD INCREASE MODERATELY FOR REMAINDER OF YEAR, AND THAT COMPENSATION PER MAN-HOUR WOULD RISE BY ABOUT 9.5 PERCENT, UNDERLYING RATE OF INFLATION WAS ESTIMATED AT 5.5 - 6 PERCENT. HOWEVER, U.S. EMPHASIZED THAT DESPITE HEAVY COLLECTIVE BARGAINING CALENDAR IN 1976, INCREASES IN COMPENSATION PER MAN-HOUR WERE RUNNING AT 7.5 PERCENT. COMBINING FAVORABLE WAGE OUTLOOK WITH EXPECTED GAINS IN PRODUCTIVELY, U.S. REP PLACED INCREASE IN UNIT LABOR COSTS AT 4 PERCENT FOR 1976, AND ADDED THAT GIVEN THESE FACTORS IT APPEARS THAT PROGRESS HAS BEEN MADE IN REDUCING UNDERLYING RATE OF INFLATION (WHICH MAY NOW BE RUNNING AT ABOUT 5 PERCENT). U.S. INDICATED THAT CONTINUED MODERATION IN WAGE INCREASES SHOULD CONTINUE THROUGH 1977, NOTING THAT (A) MAJOR UNION (STEEL WORKERS) BARGAINING IN 1977 HAS "NO STRIKE PLEDGE" AND HAS BEEN COMPENSATED FOR PAST COST-OF-LIVING INCREASES; (B) MOST WAGE INCREASES GOVERNED BY CONTRACTS SIGNED IN 1975-76. THESE ADJUSTMENTS WERE "FRONTLOADED" AND THUS INCREASES SHOULD BE MODERATE IN 1977; (C) CONTINUED SLACK IN LABOR MARKET SHOULD MILITATE AGAINST EXCESSIVE WAGE INCREASES IN MARKET-RESPONSIVE NON-UNION SECTOR. SECRETARIAT FORECASTS 5.3 PERCENT INCREASE IN GNP DEFLATOR IN 1976, WITH SOME ACCELERATION TO 6.3 PERCENT (ANNUAL RATE) IN FIRST HALF OF 1977. U.S. FOUND SECRETARIAT FORECASTS REASONABLE, BUT AGREED WITH CANADIAN POINT

THAT RISKS COULD WELL BE ON UPSIDE. U.S. FELT THIS
UPSIDE RISK AND ASSYMETRY OF POLICY RESPONSE TO FORECAST
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ERRORS (E.G. EASIER TO LOWER TAXES THAN TO INCREASE
THEM) ARGUED FOR PRUDENT DEMAND MANAGEMENT POLICY STANCE.

6. SECRETARIAT STRESSED THAT MODERATION IN WAGE
INCREASES COULD BE SHORT-LIVED, AND STATED JUDGMENT
THAT SHARP INCREASE IN PROFITS FORECAST FOR 1976 AND
1977 COULD TOUCH OFF A WAGE EXPLOSION. IN REFDON CON-
CLUSIONS, SECRETARIAT REMARKED THAT DEMAND MANAGEMENT
POLICY ALONE MIGHT NOT BE SUFFICIENT TO PREVENT SUCH A
DEVELOPMENT, AND RECOMMENDED THAT U.S. ESTABLISH AN
INCOMES POLICY TO RESTRAIN GROWTH OF PROFITS AND WAGES.
U.S. REACTED SHARPLY TO SECRETARIAT RECOMMENDATION, AND
STRESSED THAT INCREASED PROFITS ESSENTIAL TO GET INVEST-
MENT NECESSARY TO SUSTAIN RECOVERY AND TO ABSORB
UNEMPLOYMENT. INCREASED INVESTMENT ALSO NECESSARY TO
AVOID SUPPLY BOTTLENECKS WHICH COULD EMERGE AS SERIOUS
PROBLEM IN POST-1977 PERIOD (BUT NOT BEFORE). FURTHER-
MORE, U.S. REMARKED THAT SHARE OF PROFITS IN NATIONAL
INCOME HAS DECLINED STEADILY SINCE 1968; RECENT INCREASE
IN PROFITS NOT SUFFICIENT TO RETURN PROFIT SHARE TO
1968 LEVEL. PICKING UP POINT MADE BY FRENCH EXAMINER
(CORTESSE), U.S. NOTED THAT PROFIT INCREASES MODERATE
(AND POSSIBILITY INSUFFICIENT TO SUPPORT SIGNIFICANT

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RISE IN INVESTMENT) WHEN VIEWED RELATIVE TO INCREASED REPLACEMENT COST OF CAPITAL EQUIPMENT. U.S. STATED THAT WAGE PUSH WAS NOT MAJOR CAUSE OF INFLATION IN U.S. MOREOVER, U.S. ARGUED THAT TO EXTENT THAT RISK OF WAGE-PUSH INFLATION EXISTED, LINE OF CAUSATION WOULD RUN NOT FROM PROFITS TO WAGES TO PRICES, BUT FROM PRICE INCREASES OF CERTAIN IMPORTANT ITEMS (E.G. FOOD) TO WAGES TO PRICES.

7. CANADIAN EXAMINER (SLATER) CAME OUT STRONGLY IN FAVOR OF NEGATIVE U.S. VIEWS ON INCOMES POLICY, AND EMPHASIZED INAPPROPRIATENESS OF APPLYING A EUROPEAN SOLUTION IN U.S. CONTEXT. HE POINTED OUT THAT (A) CHANNELS OF COMMUNICATION BETWEEN GOVERNMENT, BUSINESS AND LABOR WERE OPEN IN U.S.; (B) STRUGGLE FOR INCOME SHARES IS MUCH LESS A PROBLEM IN U.S. THAN ELSEWHERE IN OECD. SLATER CONCLUDED THAT INCOMES POLICY NOT RELEVANT IN U.S. CONTEXT, AND URGED SECRETARIAT TO RECONSIDER ITS RECOMMENDATION IN REFDOC THAT U.S. ADOPT AN INCOMES POLICY. EDRC CHAIRMAN SUPPORTED CANADIAN LIMITED OFFICIAL USE

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POSITION, AND ADDED THAT USE OF TERM "INCOMES POLICY" IN PUBLISHED REPORT WOULD BE COUNTER-PRODUCTIVE GIVEN DISASTEROUS U.S. EXPERIENCE WITH SUCH POLICIES IN EARLY 1970'S. FEELING BATTERED, SECRETARIAT AGREED TO WATERED-DOWN RECOMMENDATION UNDERLINING NEED TO USE ALL AVENUES OF COMMUNICATION TO HELP MODERATE PRESSURE FOR EXCESSIVE INCREASES IN INCOMES.

8. CURRENT ACCOUNT: U.S. (WIDMAN) IN GENERAL AGREEMENT WITH SECRETARIAT VIEW THAT \$15 BILLION SWING TOWARD DEFICIT IN U.S. CURRENT ACCOUNT BETWEEN 1975 AND 1976 (FROM \$11.6 BILLION SUR-LUS IN 1975 TO \$3.5 BILLION DEFICIT FORECAST FOR 1976) WAS LARGELY DUE TO FACT THAT U.S. IS LEADING RECOVERY IN OECD AREA. REFERRING TO SECRETARIAT PROJECTION THAT U.S. CURRENT ACCOUNT

DEFICIT WOULD NARROW IN FUTURE AS OECD COUNTRIES GROWTH RATES APPROACHED THAT OF U.S., U.S. COMMENTED THAT EVOLUTION OF OUR CURRENT ACCOUNT WOULD DEPEND IMPORTANTLY ON ADJUSTMENT POLICIES ADOPTED BY OTHER COUNTRIES, PARTICULARLY DEFICIT COUNTRIES. SPECIFICALLY, U.S. EMPHASIZED THAT AS DEFICIT COUNTRIES ADJUST, AS THEY MUST, CURRENT ACCOUNT DEFICITS WILL APPROPRIATELY FALL ON STRONGER COUNTRIES WHICH ARE ABLE TO ATTRACT CAPITAL. U.S. ALSO UNDERLINED STRONG COUNTRY RESPONSIBILITIES IN INTRA-OECD ADJUSTMENT PROCESS ALONG LINES REF B. IN THIS CONNECTION, U.S. NOTED THAT WE HAD NO CURRENT ACCOUNT TARGET, THAT WE WERE PREPARED TO ACCEPT A DEFICIT AND THAT THIS WOULD BE CONSISTENT WITH NEEDS OF THE WORLD ECONOMY.

9. U.S. TOOK SHARP ISSUE WITH IMPLICATION REFD0C THAT RECENT APPRECIATION OF DOLLAR WAS CONSISTENT WITH IMPROVEMENT IN U.S. RELATIVE COST POSITION AND THAT DOLLAR WAS NOW AT ABOUT THE "RIGHT" LEVEL. U.S. RECALLED OUR CRITICISM EXPRESSED AT MAY WP-3 MEETING OF SECRETARIAT'S "COMPETITIVENESS" PAPER, AND STRESSED THAT BECAUSE FACTORS DETERMINING EXCHANGE RATES WERE LEGION (CAPITAL FLOWS' EXPECTATIONS, ETC.), ATTEMPTS TO IDENTIFY AT THE "RIGHT" RATE ON BASIS OF TRADE COMPETITIVENESS WERE POINTLESS. ALLUSION TO COST/EXCHANGE RATE LINK WILL NOT APPEAR IN REVISED DRAFT SURVEY.
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10. DEMAND MANAGEMENT POLICY; FISCAL POLICY: STIMULATORY FISCAL MEASURES IMPLEMENTED IN 1976 RESULTED IN FULL EMPLOYMENT DEFICIT OF \$8 BILLION. IN REFD0C, SECRETARIAT NOTED THAT ADOPTION OF PROPOSED ADMINISTRATION BUDGET FOR FY77 WOULD RESULT IN SIGNIFICANT SWING TOWARD CONTRACTION. SECRETARIAT ALSO COMMENTED THAT BUDGET PROPOSED BY CONGRESS (IN FIRST CONCURRENT RESOLUTION) ALSO IMPLIED A RELATIVELY STRONG SHIFT TOWARD RESTRAINT. THUS, SECRETARIAT CONCLUDED THAT ADOPTION OF EITHER ADMINISTRATION OR CONGRESSIONAL PROPOSALS WOULD LEAD TO SUBSTANTIAL FISCAL TIGHTENING. U.S. REP PRESENTED DETAILED EXPENDITURE AND REVENUE ESTIMATES WHICH DEMONSTRATED THAT NEITHER CONGRESSIONAL NOR ADMINISTRATION BUDGET PROPOSALS IMPLIED MARKED CONTRACTIONARY MOVEMENTS. SECRETARIAT ALSO ARGUED THAT FISCAL POLICY STANCE UNCERTAIN, SINCE ADMINISTRATION AND CONGRESSIONAL PROPOSALS DIFFERED WIDELY. U.S. REP RESPONDED THAT BECAUSE OF CONGRESSIONAL ACTION, ADMINISTRATION'S FY77 EXPENDITURE ESTIMATES, RECENTLY PUBLISHED IN JULY BUDGET UPDATE, WERE REVISED UPWARD FROM LEVELS CONTAINED IN ORIGINAL BUDGET DOCUMENT. U.S. ARGUED THAT REVISED

EXPENDITURE ESTIMATES OF ADMINISTRATION IMPLIED SWING

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TOWARD CONTRACTION ONLY SLIGHTLY LARGER THAN CONGRESSIONAL BUDGET, AND CONCLUDED THAT THERE WAS THUS LITTLE UNCERTAINTY SURROUNDING FY77 FISCAL POLICY. SECRETARIAT AGREED TO ADJUST DRAFT SURVEY ACCORDINGLY.

11. MONETARY POLICY: SECRETARIAT DESCRIBED STANCE OF U.S. MONETARY POLICY IN 1975 AS CAUTIOUSLY ACCOMMODATIVE, AND INTERPRETED LOWERING IN EARLY 1976 OF TOLERANCE RANGES FOR GROWTH OF MONETARY AGGREGATE AS SHIFT TOWARD RESTRAINT. U.S. SAID THAT TERM "CAUTIOUSLY ACCOMMODATIVE" COULD HARDLY DESCRIBE 1975 MONETARY POLICY STANCE, AS INTEREST RATES DECLINED DURING MOST OF THE YEAR. SLOW GROWTH OF MONETARY AGGREGATES IN LATE 1975 PROBABLY ATTRIBUTED TO DOWNWARD SHIFT IN DEMAND FUNCTION FOR MONEY. SIMILARLY, U.S. NOTED THAT LOWERING OF RANGES IN EARLY 1976 WAS RESPONSE TO DOWNWARD SHIFT IN DEMAND FOR MONEY AND THEREFORE SHOULD NOT BE

INTERPRETED AS A TIGHTENING OF MONETARY POLICY.

12. U.S. STRESSED THAT GUIDELINES FOR MONETARY GROWTH
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SHOULD BE SEEN AS FLEXIBLE RANGES RATHER THAN AS RIGID
TARGETS. TO MAKE THIS POINT, U.S. EXPLAINED THAT
RANGES UNDER CONTINUOUS REVIEW, THAT RANGES CAN BE
ADJUSTED, AND THAT EVEN IF RANGES REMAIN CONSTANT BASE
CAN BE CHANGED AT QUARTERLY INTERVALS (AS THEY WERE IN
EVERY QUARTER DURING 1975). U.S. ADDED, HOWEVER, THAT
FLEXIBILITY OF RANGES WAS NOT FUNCTIONAL EQUIVALENT OF
THEIR ABSENCE (AS SUGGESTED BY CANADIANS). RATHER THE
ANNOUNCEMENT OF RANGES WAS A CLEAR SIGNAL TO PUBLIC OF
AUTHORITIES' INTENT THAT MONETARY POLICY WOULD BE
STEADY, THEREBY AVOIDING THE DESTABILIZING SWINGS
CHARACTERISTIC OF THE EARLY 1970'S, AND WOULD BE
CONSISTENT WITH OBJECTIVE OF REDUCING INFLATION.
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